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The Crystal Report on Executive Compensation



A \$75 Million Consolation Prize?

by Graef Crystal

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In Oct. 2008, Aubrey McClendon, the CEO and co-founder of Oklahoma City-based oil and natural gas producer Chesapeake Energy Corp., was forced to sell almost all his company shares – \$569 million worth – to meet margin calls. Two-and-one-half months later, his board awarded him a special bonus of \$75 million. Were these two isolated events? Or was the bonus a sort of consolation prize for losing so much money?

I have no definitive answer to this question, but, in my opinion, the timing of the two events has a certain odor to it.

For openers, with the exception of Goldman Sachs Group in its best year, I cannot ever recall a CEO receiving a bonus this large. In fact, Mr. McClendon received two semi-annual bonuses in addition to the \$75 million amount, for a grand total of \$77 million.

Mr. McClendon was once a billionaire. In a proxy filed on April 29, 2008, he was shown to be holding shares worth \$1.5 billion.

But in that same proxy statement, shareholders were told that almost all his shares were “held in bank or brokerage margin accounts or escrow accounts securing brokerage accounts”.

Then the overall stock market crashed beginning in Oct. 2008. And in the space of three days, Oct. 8, Oct. 9 and Oct. 10, Mr. McClendon was forced to sell 31.5 million shares. Those shares brought \$569 million before taxes. They would have brought more had not Chesapeake’s share price dropped 26 percent between Oct. 8, 2008 and Oct. 10, 2008.

According to Chesapeake’s preliminary proxy statement filed on this April 20, he was shown to be holding only 502,298 shares worth, as of the close on this May 1, \$10.5 million.

Company Performance

One factor that might explain the rationale for this \$75 million special bonus could be brilliant performance. But for Chesapeake, we have a decidedly mixed picture in 2008:

- Net sales rose 49 percent to \$11.6 billion.
- Operating income rose 62 percent to \$4.3 billion.
- But net income declined 50 percent, while diluted EPS declined 57 percent.
- And for good measure, total return was negative 59 percent versus negative 37 percent for the Standard & Poors 500 Index.

But perhaps the S&P 500 Index is not the ideal comparator group. At least, that's the argument made by Chesapeake in its preliminary proxy statement filed on April 20. The company inserted a chart showing little correlation between its stock price over time and the progression of the S&P 500 but a very high correlation between its stock price and the price of natural gas.

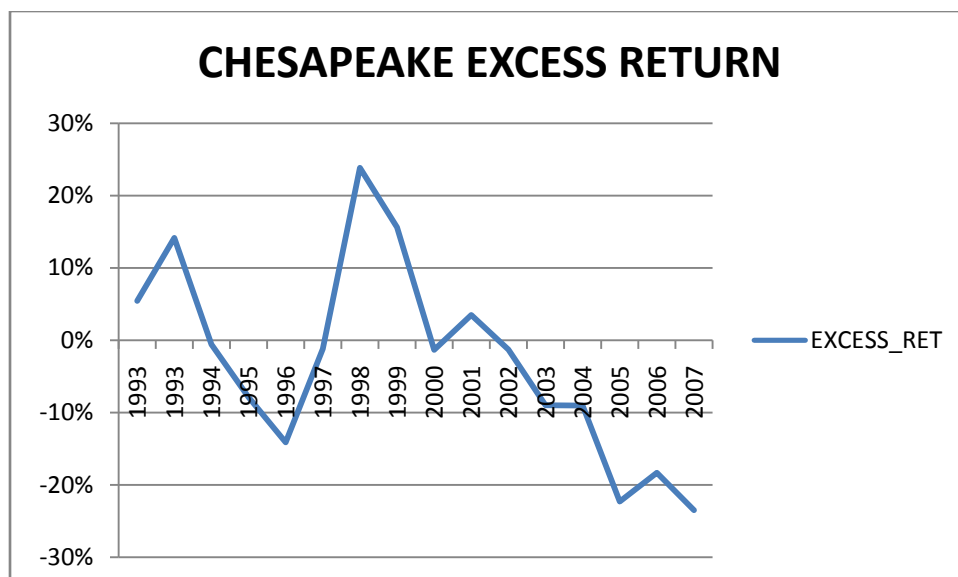
Because of this, I decided to compare Chesapeake's long-term total returns to those of the 39 companies comprising the S&P 500 Energy Index.

Although Mc. McClendon co-founded the company in July 1989, it did not go public until Feb. 5, 1993.

I compared Chesapeake's total return in 16 different time windows, the first of which began on Feb. 5, 1993. The second time window began on Dec. 31, 1993. Each succeeding time window began one year later, i.e., Dec. 31, 1994, Dec. 31, 1995 and so forth. All 16 time windows ended Dec. 31, 2008.

In each time window, I deducted from Chesapeake's annual total return the total return on the S&P 500 Energy Index to produce a so-called "excess return".

The results may be seen on the following chart:



The median excess return in the 16 time windows was negative 1.3 percent. So, for all practical purposes, Chesapeake's performance equalled that of the energy industry.

But the six narrowest time windows all produced negative excess returns, with the deficit increasing to negative 23 percent for the single year ended Dec. 31, 2008.

Buttressing this finding are the 2008 returns of the four companies in the oil and gas industry the current market caps of which are closest to Chesapeake's market cap. Recall here that Chesapeake's total return for 2008 was negative 58 percent. XTO Energy Inc. had a negative return of 30.7 percent in 2008. The returns in 2008 for EOG Resources Inc., Southwestern Energy Co. and Noble Energy Inc. were, respectively, negative 25 percent, positive 4 percent and negative 37.5 percent.

From all this, I conclude that the case for having given McClendon an extraordinary reward based on his performance was exceedingly weak.

The Bonus and Other Compensation

There's another twist to this \$75 million bonus. The after-tax amount, or, according to the company, about \$44 million, must be invested alongside the company in drilling wells.

That in turn raises two questions:

- If Mr. McClendon is going to invest in every new well, why not simply have given him \$75 million of restricted shares? Of course, doing so could have called attention to the fact that he apparently gambled and lost, big time. And what he lost was company shares.

- If Mr. McClendon is going to be permitted to pick and choose which wells in which to invest, doesn't that put him in a conflict-of-interest position?

It's not that Mc. McClendon has not been treated generously in the past:

- He was awarded \$20 million of restricted stock in 2006.
- He was awarded \$21 million of restricted stock in 2007.
- And in the same year as his \$75 million special bonus, he was awarded another \$33 million of stock. (This \$33 million was artfully presented in the proxy statement. Normally, the grant date fair value of an equity award occupies the far-right column in the Grants of Plan-Based Awards Table. But in Chesapeake's case, the \$33 million figure shows up in the next to the far-right column. The far-right column contains a value of \$13 million, which if you take the time to read the footnotes, is the greatly-reduced value of the award as of April 15, 2009, the so-called "record date" for the proxy statement.)
- He also racked up \$648,000 of personal air travel in 2008.
- His "accounting costs", which the company pays, weighed in at \$527,000 in 2008. Investing in all those wells must produce some accounting headaches.
- In Dec. 2008, the very month in which the company gave Mr. McClendon a \$75 million bonus, it also purchased from him "an extensive collection of historical maps of the American Southwest, together with certain books, watercolors and photographs... for \$12.1 million, which represented his cost". I thought the company was in the natural gas business.
- In 2008, Chesapeake became a founding sponsor of the Oklahoma City Thunder, a National Basketball Association franchise, in which Mr. McClendon has a 19.2 percent interest. I thought the company was in the natural gas business.
- In 2008, the company paid approximately \$177,150 for food and beverage catering services to a restaurant in which McClendon had a 49.7 percent interest. I thought the company was in the natural gas business.

As I see it, it's virtually impossible to justify a \$75 million bonus to anyone in any company. And, in my view, that especially covers Mr. McClendon, who, it seems to me, did nothing to justify such a lavish reward.

Board Compensation Committee

The members of Chesapeake's board compensation committee are:

- Frederick Whittemore, chairman, 78, retired managing director or partner of predecessor firms of Morgan Stanley.
- Charles Maxwell, 77, senior energy analyst , Weeden & Co.
- Frank Keating, 65, former governor of Oklahoma. (Governor Keating has a daughter-in-law and a son working for Chesapeake, one of whom had total cash compensation of \$139,327 in 2008 and the other of whom had total cash compensation of \$135,242.)

2009 marks Graef Crystal's 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay.